



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Release Number: **201043041**
Release Date: 10/29/10
Date: August 6, 2010
UIL Code: 512.00-00

Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

Legend:

Foreign Corporation =

Dear :

We have considered your ruling request dated June 7, 2006, and subsequent submissions, concerning the federal income tax consequences under section 511 of the Internal Revenue Code of 1986, as amended (hereafter "Code"), relating to a proposed transaction in the manner and for the purposes described below.

Facts:

You have been recognized as a charitable remainder unitrust (hereafter "CRUT") under section 664(d)(2) of the Code and exempt from income taxation under section 664(c)(1). You were established by your trustee, who is both your grantor and your income beneficiary. Your trustee, acting on your behalf, has also established Foreign Corporation, a corporation organized under the laws of the , whose principal purpose is "the holding and managing of alternative investments such as U.S. and foreign hedge funds, partially using debt financing in conjunction with capital contributions to fund the acquisition of its portfolio of securities." Specifically, you stated that the business purpose for establishing Foreign Corporation was to allow you "to invest in certain hedge funds that would not accept investments from U.S. citizens." You represented that any income derived by Foreign Corporation will not originate from insurance activities as this term is defined in section 953. You are the sole member of Foreign Corporation, which was created solely for the purposes of investing and managing your assets. You represented that Foreign Corporation is a separate and distinct legal entity from you and that you (1) are not responsible for paying any debts of Foreign Corporation, (2) have no liability with regard to Foreign Corporation beyond your investment as a shareholder, and (3) are not required to make additional capital contributions to Foreign Corporation. You also represented that you will not engage in any debt-financing of your ownership interests in Foreign Corporation and that any income earned by Foreign Corporation may either be reinvested by Foreign Corporation or distributed to you as a dividend.

Furthermore, you have not made any representations that any other entities or individuals are or will become members of Foreign Corporation or will invest their assets in Foreign Corporation.

You have requested the following rulings:

1. That the distributive share of income and gains from investments in U.S. and foreign hedge funds, reportable by Foreign Corporation under section 704 of the Code will not constitute to you unrelated business taxable income, as defined in section 512(a) of the Code.
2. That amounts distributed by Foreign Corporation to you as dividends will not constitute to you unrelated business taxable income, as defined by section 511 of the Code.
3. That the income described in Subpart F of the Internal Revenue Code allocable to you as a result of your ownership of Foreign Corporation will not constitute to you unrelated business taxable income, as defined in section 512(a) of the Code.
4. That the formation and operation of Foreign Corporation by you does not constitute an act of self-dealing under section 4946 of the Code that would be subject to excise taxes under section 4941.

Law:

Section 511(a) of the Code, in part, imposes a tax on the unrelated business taxable income of every trust exempt from taxation under section 501(a).

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less the allowable deductions which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in section 512(b).

Section 512(b)(1) of the Code excludes from the definition of unrelated business taxable income all dividends, interest, payments with respect to securities loans (as defined in subsection (a)(5)), amounts received or accrued as consideration for entering into agreements to make loans, and annuities, and all deductions directly connected with such income.

Section 512(b)(4) of the Code provides that notwithstanding the general exclusion of dividends from unrelated business taxable income, dividends and other passive investment income derived from debt-financed property (as defined in section 514) are included as an item of gross income derived from an unrelated trade or business.

Section 512(b)(13)(A) of the Code provides that if a controlling organization receives or accrues a specified payment from a controlled entity, the controlling organization shall include such payment as an item of gross income derived from an unrelated trade or business (to the extent such payment reduces the net unrelated income of the controlled entity (or increases any net unrelated loss of the controlled entity)).

Section 512(b)(13)(C) of the Code defines the term "specified payment" as used in section 512(b)(13)(A) to mean any interest, annuity, royalty, or rent received from the controlled entity.

Section 512(b)(17) provides for the treatment of certain amounts derived from foreign corporations. Specifically, any amount included in gross income under section 951(a)(1)(A) shall be included as an item of gross income derived from an unrelated trade or business to the extent the amount so included is attributable to insurance income (as defined in section 953) which, if derived directly by the organization, would be treated as gross income from an unrelated trade or business.

The House Ways and Means Committee Report on the Small Business Job Protection Act of 1996, in describing section 512(b)(17) of the Code, states that "income inclusions under Subpart F have been characterized as dividends for unrelated business income tax purposes" and that this is the correct result.

Section 512(c) of the Code provides that if a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to such organization, such organization in computing its unrelated business taxable income shall, subject to the exceptions, additions, and limitations contained in section 512(b), include its share (whether or not distributed) of the gross income of the partnership from such unrelated trade or business and its share of the partnership deductions directly connected with such gross income.

Section 513(a) of the Code defines the term "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its exempt purpose or function.

Section 513(c) of the Code provides that a "trade or business" includes any activity which is carried on for the production of income from the sale of goods or the performance of services.

Section 514(b) of the Code defines "debt-financed property" as any property which is held to produce income and with respect to which there is an acquisition indebtedness (as defined in subsection 514(c)) at any time during the taxable year (or, if the property was disposed of during the taxable year, with respect to which there was an acquisition indebtedness at any time during the 12-month period ending with the date of such disposition).

Section 664(c) of the Code provides that a charitable remainder unitrust is exempt from income taxes for any taxable years unless it has unrelated business taxable income for such year.

Section 664(d)(2) of the Code defines a charitable remainder unitrust as a trust (A) from which a fixed percentage (which is not less than 5 percent nor more than 50 percent) of the net fair market value of its assets, valued annually, is to be paid, not less often than annually, to one or more persons (at least one of which is not an organization described in section 170(c) and, in

the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individual or individuals; (B) from which no amount other than the payments described in subparagraph (A) and other than qualified gratuitous transfers described in subparagraph (C) may be paid to or for the use of any person other than an organization described in section 170(c); (C) following the termination of the payments described in subparagraph (A), the remainder interest in the trust is to be transferred to, or for the use of, an organization described in section 170(c) or is to be retained by the trust for such a use or, to the extent the remainder interest is in qualified employer securities (as defined in subsection (g)(4)), all or part of such securities are to be transferred to an employee stock ownership plan (as defined in section 4975(e)(7)) in a qualified gratuitous transfer (as defined by subsection (g)); and, (D) with respect to each contribution of property to the trust, the value (determined under section 7520) of such remainder interest in such property is at least 10 percent of the net fair market value of such property as of the date such property is contributed to the trust.

Section 951(a)(1)(A) of the Code provides that a U.S. shareholder of a controlled foreign corporation must include in gross income its pro-rata share of the controlled foreign corporation's subpart F income for the year.

Section 952(a) of the Code defines subpart F income to include insurance income and "foreign base company income."

Section 954(a)(1) of the Code defines "foreign base company income" to include "foreign personal holding company income."

Section 954(c)(1)(A) of the Code defines "foreign personal holding company income" to include that portion of gross income which consists of dividends, interest, royalties, rents, and annuities.

Section 4941(a) of the Code provides for the imposition of tax on each act of "self-dealing" between a disqualified person and a private foundation.

Section 4941(d) of the Code states that the term self-dealing means any direct or indirect (A) sale or exchange, or leasing, of property between a private foundation and a disqualified person; (B) lending of money or other extension of credit between a private foundation and a disqualified person; (C) furnishing of goods, services, or facilities between a private foundation and a disqualified person; (D) payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person; and (E) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

Section 4946 of the Code provides that the term "disqualified person", with respect to a private foundation, includes (i) a person who is a substantial contributor to the foundation, (ii) a foundation manager, or (iii) a corporation of which a substantial contributor or foundation manager owns more than 35 percent of the total combined voting power of said corporation.

Section 4947(a)(2) provides that a charitable remainder trust is subject to the prohibitions

of section 4941 and other provisions of Chapter 42 of the Internal Revenue Code.

Section 1.512(b)-1(a)(1) of the Income Tax Regulations ("regulations") defines certain investment income to include dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), annuities, income from notional principal contracts (as defined in Treasury Regulation 26 CFR 1.863-7 or regulations issued under section 446), other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner, and all deductions directly connected with any of the foregoing items of income shall be excluded in computing unrelated business taxable income.

Section 53.4946-1(a)(1)(vii) of the Foundation and Similar Excise Taxes Regulations ("foundation regulations"), defines a disqualified person as including a trust, of which more than 35 percent of the beneficial interest is owned by a substantial contributor.

Section 53.4946-1(a)(4) of the foundation regulations, defines a person's beneficial interest in a trust, as referenced in section 53.4946-1(a)(1)(vii), as being determined in proportion to the actuarial interest of such person in the trust.

Analysis:

Rulings One, Two and Three:

The issue is whether you will have unrelated business taxable income, as defined in sections 511 and 512 of the Code, as a result of Foreign Corporation's receipt of its distributive share of income and gains, under section 704, or of the amounts distributed by Foreign Corporation to you in the form of dividends.

You have been recognized as a charitable remainder unitrust ("CRUT") and are exempt from income taxes unless you have unrelated business taxable income. See section 664 of the Code. Unrelated business taxable income is defined as the gross income derived from any regularly conducted unrelated trade or business, less certain modifications and deductions. Section 512(a)(1). The term "unrelated trade or business" is defined as any trade or business the conduct of which is not substantially related to the organization's exempt purpose. Section 513(a). You represented that you created Foreign Corporation as an investment vehicle solely for your assets and to permit you to invest in certain overseas funds that do not accept investments from U.S. citizens. Your investments in Foreign Corporation are intended to increase your investment portfolio and earn income, which purpose is not substantially related to any charitable purpose. As such, your investment income would be subject to taxation as unrelated business income under section 511. However, there is a general exception from unrelated business income taxation if the income is derived from dividends. Section 512(b)(1). Under this general exception, dividends received by you would not constitute unrelated business taxable income under section 512(a).

The exclusion of dividend income from unrelated business income taxation does not apply if dividend income is derived from the debt financing of property that generates such dividends.

Sections 512(b)(4) and 514(b). You have represented that you are the sole shareholder of Foreign Corporation. Foreign Corporation intends to invest in both U.S. and foreign hedge funds utilizing various investment techniques, including the debt financing of investment property. You have also represented that Foreign Corporation is a separate and distinct legal entity from you, and you are (1) not responsible for paying any debts of Foreign Corporation, (2) have no liability with regard to Foreign Corporation beyond your investment as a shareholder, and (3) are not required to make additional capital contributions to Foreign Corporation. Although Foreign Corporation is engaging in debt financing of investments, you have represented that you will not debt finance your ownership interest in Foreign Corporation. As such, Foreign Corporation's distributions of dividends to you would not constitute unrelated business income under sections 512(b)(4) and 514(b).

Section 512(b)(17) of the Code provides for the special treatment of certain amounts derived from foreign corporations. Specifically, this section provides that "any amount included in gross income under section 951(a)(1)(A) shall be included as an item of gross income derived from an unrelated trade or business to the extent the amount so included is attributable to insurance income." Section 512(b)(17). Section 951(a)(1)(A) requires that "a U.S. shareholder of a controlled foreign corporation must include in gross income its pro-rata share of the controlled foreign corporation's subpart F income for the year." The legislative history of section 512(b)(17) makes clear, however, that Congress intended that subpart F income not be defined as unrelated business income when the income is not attributable to insurance income. Specifically, The House Ways and Means Committee Report on the Small Business Job Protection Act of 1996, in describing section 512(b)(17), states that "income inclusions under Subpart F have been characterized as dividends for unrelated business income tax purposes." As such, income described in Subpart F of the Internal Revenue Code allocable to you as a result of your ownership of Foreign Corporation will not constitute unrelated business taxable income under section 512.

Ruling Four:

The issue is whether your formation and operation of Foreign Corporation will constitute an act of self-dealing under section 4941 of the Code, subjecting you to excise taxes under section 4941.

You have been recognized as a CRUT under section 664 of the Code. Pursuant to section 4947(a)(2), a CRUT is subject to the prohibition in section 4941 against acts of self-dealing between a private foundation and a disqualified person, and is treated, for purposes of sections 4947(a)(2) and 4941, as a private foundation. Section 4941(d) broadly defines "self-dealing" as a transaction between a private foundation and a disqualified person, including (i) any direct or indirect sales or exchanges between a private foundation and a disqualified person or (2) the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation. Section 4946 provides that the term "disqualified person", with respect to a private foundation, includes (i) a person who is a substantial contributor to the foundation, or (ii) a foundation manager. Under section 53.4946-1(a)(1)(vii) of the foundation regulations, a disqualified person is defined as including a trust, of which more than 35 percent of the

beneficial interest is owned by a substantial contributor. See section 53.4946-1(a)(4) as to determination of beneficial interests.

In this transaction, you are investing certain assets of yours in Foreign Corporation. These assets are not subject to any debt or liability, and no debt is created by you or on your behalf to effectuate this purpose. Foreign Corporation is a newly created corporation, which is created by you as an investment vehicle solely for your assets, with Foreign Corporation's sole purpose to invest and manage these assets on and for your behalf. Any dividends paid by Foreign Corporation are paid solely to you as the sole member of Foreign Corporation. We find that Foreign Corporation, a wholly owned subsidiary, is not a disqualified person with respect to you, within the meaning of section 4946 of the Code and section 53.4946-1(a) of the foundation regulations, as it would not be a disqualified person with respect to a private foundation in your position. Therefore, we conclude that the formation and initial funding of Foreign Corporation by you will not constitute an act of self-dealing subjecting you to an excise tax under sections 4946 and 4941.

Conclusion:

Accordingly, based on the information submitted in your ruling request, we rule as follows:

1. That the distributive share of income and gains from investments in U.S. and foreign hedge funds, reportable by Foreign Corporation under section 704 of the Code will not constitute unrelated business taxable income, as defined in section 512(a) to you.
2. That amounts distributed by Foreign Corporation to you as dividends will not constitute unrelated business taxable income, as defined by section 511 of the Code, to you.
3. That the income described in Subpart F of the Internal Revenue Code includible by you as a U.S. shareholder of Foreign Corporation will not constitute unrelated business taxable income, as defined in section 512(a) of the Code to you.
4. That the formation and initial funding of Foreign Corporation by you does not constitute an act of self-dealing as defined under section 4941 of the Code that would subject you to excise taxes under section 4941.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your permanent records.

We express no opinion as to whether any entity described in this ruling may be deemed a foreign financial account for foreign bank account report ("FBAR") purposes and may be required to file an FBAR.

Finally, we express no opinion on any transaction other than the one described in this submission and we express no opinion as to any consequences under section 664.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Theodore R. Lieber
Manager, Exempt Organizations
Technical Group 3

Enclosure
Notice 437